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"VALUE CHAIN FINANCE - INITIATIVES IN INDIA"

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Abstract

The nature of laws that govern the financial sector, as well as the quality of the institutions that enforce those laws, will largely determine the shape, size and depth of the financial sector. Of particular importance are the laws and institutions that facilitate/ promote or discourage/inhibit secured lending by influencing the ease with which agricultural and other rural assets can be used as collateral. These laws need to be reviewed and amended from time to time and financial/legal literacy and credit counseling in rural areas need to be continuously provided to users in order to ensure orderly growth of rural financial markets, since these are two issues of particular concern for the development of Rural Financial Markets(RFMs) in most developing countries. The experiences also confirm that mere establishment of an appropriate enabling environment does not guarantee that people will use their assets as collateral or use them prudentially. In rural areas, peoples' understanding of their rights to own property and utility value of property owned is not adequate for them to seize available opportunities for their socio-economic development that their ownership makes possible. Efforts are, therefore, necessary to make them fully aware/educate potential borrowers as to the rights and responsibilities associated with property ownership, which can help them leverage their assets while understanding the risks in doing so.

A well-conceived banking and credit policy and its legal and regulatory framework are critical to the growth and sustainability of the financial sector. Macro-level policies governing such aspects, such as interest and exchange rates, reserve requirements, and repatriation of funds can have significant impact on the liquidity within the financial sector and provision of financial

services. The nature of laws that govern the financial sector, as well as the quality of the institutions that enforce those laws, will largely determine the shape, size and depth of the financial sector. Of particular importance are the laws and institutions that facilitate/ promote or discourage/inhibit secured lending by influencing the ease with which agricultural and other rural assets can be used as collateral. These laws need to be reviewed and amended from time to time and financial/legal literacy and credit counseling in rural areas need to be continuously provided to users in order to ensure orderly growth of rural financial markets, since these are two issues of particular concern for the development of **Rural Financial Markets(RFMs)** in most developing countries. The experiences also confirm that mere establishment of an appropriate enabling environment does not guarantee that people will use their assets as collateral or use them prudentially. In rural areas, peoples' understanding of their rights to own property and utility value of property owned is not adequate for them to seize available opportunities for their socio-economic development that their ownership makes possible. Efforts are, therefore, necessary to make them fully aware/educate potential borrowers as to the rights and responsibilities associated with property ownership, which can help them leverage their assets while understanding the risks in doing so. Legal assistance centers can further enable small entrepreneurs and rural households in their endeavors to understand commercial value/socio-economic benefits of property owned and legal processes, such as contract enforcement, mediation and foreclosure. Better information on processes for utilizing collateral may be necessary to encourage lenders to enter the market, in cases of nascent property rights systems, excessive bureaucracy or other problematic environments. Clarity in the claims process for different types of collateral in the case of default could further widen the range of assets lenders are willing to accept as collateral. As an integral part of secured lending mechanism to give a boost to agricultural development in developing countries a good number of international agencies have invested significant resources to understand and operationalize the concept of Value Chain Finance This concept of innovative financing present significant opportunities in developing countries to harness hitherto untapped potential for financing rural households in general and small farmers & women in particular through putting in place appropriate enabling environment & legal framework. .

Value Chain Finance

Initiatives in India : The All India Rural Credit Survey Report as early as in 1954 emphasized the paramount need to link agricultural credit with the supply of inputs of farm production, provision of technical services, transport, storage, processing, warehousing and marketing of farm products in order to help small farmers to raise farm productivity, production and profitability of farming enterprise. The report suggested conceptualizing this recommendation as Integrated Agricultural Credit System and desired to operationalize the same. This has been systematically and successfully implemented by sugar factories in cooperative sector since 1970s. Anand Milk Union Limited [AMUL] since late 1960s has been implementing a business model in cooperative sector, just a prototype to modern 'Value Chain' to provide to all its milk producer-members all services integrating milk production, procurement, processing and marketing with value addition at each stage. **Amul** procures 10 million kg of milk daily from 2.5 million farmers. The National Commission on Agriculture in 1971 recommended setting up Farmers' Service Societies, which should -

[i] provide a total system for building up and expanding all activities facilitating the modernization of agriculture including organization of services and marketing and improving it

[ii] have a comprehensive connotation of agriculture to make it almost coterminous with rural development covering all production needs of rural households and

[iii] facilitate and provide for linkages between finance and services for current inputs as well as for investment in land development, irrigation and farm equipment.

Acknowledging the special socio-economic needs of tribal families actively associated with forestry similar model called Large-sized Advise Multi-purpose Societies [LAMPS] was recommended. LAMPS should -

[i] Provide under a single roof, all types of credit including those for meeting social obligations and consumer requisites

[ii] Provide technical guidance in intensification and modernization of agriculture and

[iii] Arrange for the marketing of agricultural and minor forest produce, besides the products of other subsidiary occupations of the tribal families.

While AMUL and sugar cooperatives succeeded in their efforts to integrate financial and non-financial services through implementing a business model and helped farmers in India, the

concept of Farmers' Service Societies and LAMPS could not make any progress because of lack of proper understanding the concept, professional expertise, capacity building training and institutional capacity to effectively coordinate among involved agencies.

Concept: The experience of financing agriculture by RFIs in most developing economies over the last four decades provides valuable lesson to experiment with Value Chain Finance approach.. A large number of small farmers as producers of high-value crops [including milk, meat, eggs, fish etc. find extremely difficult to move from pillars to post, viz. to RFI for credit, to different suppliers for seeds, fertilizers, pesticides, to Government officials for technical guidance on production, to processor for processing, to traders for marketing the farm products, leave alone arranging for transport, storage etc. In the process farmer's precious resources [time, human and finance] are wasted and not much income is generated to repay bank credit and interest, leave apart money to eke out a living for a family. In simple terms value chain focuses on a set of factors that transform a product from the raw material stage to the final consumption stage adding value to the product at each stage. These Value chains are at the center of high-impact and sustainable approach focused on improving entrepreneurship, productivity, competitiveness, and small and medium enterprises growth. According to **Prof. Ronald Chua of the Asian Institute of Management,** a value chain is a whole range of activities and services required to bring a product or service from idea and input stage to the market. This includes different players with a wide range of technical, business and service providers starting with the farmers back in the rural areas leading to the bigger global market. **Land Bank of the Philippines' Liduvino S. Geron** defines a value chain system as a full range of activities to turn a product in a form that is sold and consumed. Value is added to raw materials and they undergo varied processes to become a final product. The process aims to deliver maximum value at the least possible costs. In agriculture, the range of activities starting from production to manufacturing and marketing until the product reaches the consumers is important. In other words Value chain financing is an approach to identify where the financing needs are, where are the financing gaps, who can provide the financing, and what are the ways to improving access to financing. The Value Chain Finance approach helps RFIs integrate financial services with non-financial services that can facilitate easy flow of commodities and services from producers to consumers. The emergence of supermarkets in major cities explains this business relationship

better by procuring farm products directly from farmers in rural areas and supplying to urban consumers. The process of economic globalization has opened up opportunities to make small farmers' farming a commercially viable farming enterprise by establishing organic relationship between production at farmer's field and marketing to consumers directly. Value Chain Finance approach is a potential mechanism to make this possible which can also facilitate RFIs to penetrate widely and deeply in rural areas. The value chain finance approach envisages clusters and sub-sectors of economic activities as a continuous chain with value addition at each successive link while converting raw materials into finished products and marketing them. The value chain system necessitates effective coordination and good governance among the various agencies involved in the economic activities. Analysis of business and financial environment at macro level would focus on initiating decisions regarding product design, production process, technology, quality standards, and quantity produced to make agri-business competitive and cost-effective. Putting in place Value Chain Finance system requires huge financial investment and in the process brings a series of changes in farm production and procurement systems, distribution channels, financial markets, and the use of information technologies in the food industry. The approach seeks to explore vast possibilities to improve the existing products, processes, functions, and the sector. RFIs have a significant role for a specific cluster or sub-sector using value chain approach. The entrepreneurs keen to establish Value Chain System consider the sound financial system as one of the prerequisites to facilitate the smooth flow of commodities from producers to consumers. In consultation with RFIs they explore possibilities for smooth flow of finance within the individual components of value chain as well as among the participants of Value Chain System and capitalize potential linkage between chain participants and well-developed RFIs. This effort boosts the growth of chain or cluster and rural financial market. Multilateral financial institutions and donors consider the flow of finance through value chain system for high-value crops as a means to enhance competitiveness and more importantly, as a more appropriate pro-poor approach to rural finance. For formal financial institutions, financing the Value Chain can be a means to effectively deliver financial services. Experience suggests that the value chain financing complements the financial systems to substantially increase agricultural finance, thereby implying that value chains are another way to improve farmers' access to rural finance and improve their income levels.

Traditional System: In developing countries, in addition to informal moneylenders non-financial enterprises, such as input suppliers, processors and other product traders are an important source of rural finance, more importantly to small farmers as they often provide credit or in inputs to farmers at the time of planting, repayable upon harvest. In some cases, the intermediary accepts a portion of the producer's output, often at a price agreed to when the credit is issued. Despite the fact that these contractual relationships are less advantageous to the producers at times, they are still [when banking has significantly progressed and technologically advanced] generally preferable in the absence of easy and reliable access to more conventional formal financial services. Not only these relationships facilitate small farmers' access to input supply and output marketing system but also are an important source of technical information to farmers. Thus, this system has become a dynamic and integral part of rural economy contributing to the agricultural development. It is, therefore, necessary for formal financial institutions to learn lessons from this traditionally established economic system and explore mechanisms that promote mutually beneficial relationships between non-financial entities and small agricultural producers that improve and guarantee the latter's access to assured availability of hassle free and adequate credit on time. Opportunities to expand these market chain relationships through the engagement of formal financial institutions are indeed significantly vast and promising, which need to be explored and exploited in a systematic manner by designing a Value Chain Financial System. .

Gaps in Traditional System: The empirical as well as anecdotal evidences, in the implementation of this traditional system at field level reveal several shortcomings/deficiencies, such as [i] While trader-supplied credit and contractual arrangements with processors has been found to be the best option a producer has for financing production, traders or processors often have been enjoying virtually a spatial monopoly and resulting credit contracts have neither been competitive nor fair.

[ii] Depending on the region and crop, the terms of the contract places the producers at a severe disadvantage

[iii] Absence of competition due to limited number of traders in the region and lack of transparency in the executed contracts between the producer and trader leads to higher costs of

credit for producers. In fact, actual cost of the loan extended by the trader is not known [very high] at a minimum price differences for product sold to the trader

[iv] Many farmers cannot access larger markets [where they might receive better price] for their product and, therefore, they have to compulsorily depend upon the traders operating in their region and contend with the price offered by them

[v]Even if the supplier/trader credit is available to small farmers more efficiently, the limited liquidity of non-financial agents restricts considerably their ability to meet the emerging credit needs of small farmers to develop agriculture and thereby support economic growth through these arrangements. In fact, most input suppliers, processors, and other trading intermediaries are not in the regular business of financial intermediation and, therefore, have limited liquidity. Without access to additional funds, they too have to limit the number of contractual relationships despite they are eager and willing to do so

[vi] Moreover, unless traders have established relationships with producers, they are reluctant to provide credit on a contractual basis and, therefore, it is difficult for small producers to gain access to these business networks

[vii] The transaction costs associated with a large number of small producers, make working with low-volume producers a less attractive investment for traders than working with large operations.

[viii] The liquidity problems that producers experience as a result of the seasonality of production can be smoothed by non-financial mechanisms.

[ix] Prices for most commodities are the lowest at harvest time when the supply is very high, and are higher at the time of planting as also later in the season. This price fluctuation can be problematic for farmers who need to sell their product at harvest in order to repay the loans that financed production. Without a means to store their output for sale when prices are more optimal, and to cover loan or working capital expenses until later in the season, many farmers get locked into low-input, low-return production strategies. Recognizing the limitations of formal financial institutions to provide adequate, hassle free and timely credit to a very large number of small farmers in developing countries on one hand and that of liquidity problems of non-financial agencies on the other, the concept of linking non-financial institutions with financial markets is a key to enabling small farmers to develop their agriculture, thereby expanding

economic growth in rural areas. Since many different types of institutions provide financial services to agricultural producers, ways and means need to be found out and an effective system should be designed so as to facilitate expansion of these services to benefit small producers and help them make better use of the potential of these existing markets.

Organized efforts: One of the serious problems being experienced by small farmers has been, as individuals, their inability to bargain reasonably higher prices for their farm produce in the market. In this situation, they can exercise significant influence on output prices and build better trade relationships, if they are motivated to form "*producers associations"* to jointly market their produce. Associations in order to demand higher prices for their produce in the market can guide/impress upon their members to produce farm products of superior quality and of international standards required for exports, through adoption of improved production and post-harvest technology. Association's help to members integrating technological guidance with timely availability of quality and reasonably priced inputs of production [seeds, fertilizer, pesticides] can certainly increase productivity and minimize cost of production per unit of output. There are excellent examples of Associations adding *value* to members' produce through "*product branding*" and quality "*seals of assurance*". Associations can also help lower transaction costs for traders as well, since they can deal with a single, larger entity rather than dealing individually with many farmers. Farmers, with the help of producers associations can make efficient use of *warehouse receipt systems*, since the minimum quantity required for storing in the warehouse often exceeds the capacity of individual small producers. Governments, RFIs, NGOs, Donors have a role to motivate and facilitate small producers to form producers association for which they can help put in place a system with a legal frame work in the country, producers draft legal document, complete legal and registration formality and subsequently institutional strengthening as they expand operations. Associations have a role to educate small producers on the potential benefits of having their own legally registered Associations on one hand and educating traders, input suppliers and others on the other to help them understand the potential benefits of working with Associations, such as securing on a continuing basis and on time produce of superior quality and incurring lower transactions costs. Donors can also help Associations tie-up with larger business corporations and export houses to expand the market for

their products. Government and the country's Central Bank can put in place effective system/institution to redress farmer-producers' grievances.

Participation of RFIs : Under the traditional system, non-financial agencies have access to better information about their clients [small producers] and are able to provide some/limited technical services to them. However, they have limited liquidity [financial resources] with which they can finance only limited number of producers. As against this, formal financial institutions have significantly greater liquidity and are well equipped to offer a wide range of financial services to a large cross section of entrepreneurs comprising farmers, input manufacturers and suppliers, traders and warehouse owners, exporters etc. The concept of linking formal financial institutions and non-financial agencies in integrating the provision of financial and non-financial services through supplier/trader credit or contractual arrangements can "*harness the respective advantages of both".* In this relationship, the non-financial partner is able to expand its activities by accessing funds from the financial institution whereas the financial institution benefits from the lower transaction and monitoring costs and significantly increasing its outreach [small farmers' clientele]. The small producers also benefit profusely since not only do they have reliable and assured access to a wider range of products/services [credit, inputs of production, technical guidance, storage and marketing facilities] but also they are able to secure larger loan sizes through/from the financial institution than they could through non-financial entities.

Conclusion: The linkages can be facilitated through creating a mechanism /intermediaries that jointly offer technical assistance, help farmers access finance, inputs and establish relationship with traders. Donors can provide fund to start the institution, which could operate either as a business entity or an NGO. The institution can help farmers' access finance, require that farmers adequately use its technical assistance program in order to improve their productivity, output and quality of produce and increase farmers' chances of repayment. Building capacity in these linking institutions could help farmers' access new services, improve productivity of resources, increase healthy competition among input suppliers/traders, and strengthen market networks in rural areas.

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